Central Intelligence Agency
Washington, D.C. 20505

DCI/DDCI Executive Staff

17 June 1986

NOTE FOR: DDCI

SUBJECT: Mexico

You are scheduled to go to State Department tomorrow for a meeting on Mexico with Armacost, Abramowitz, Abrams and Darman at 1415. Included you will find:

TAB A Talking points from ALA recounting recent developments.

TAB B A memo from ALA produced for the 5 June SIG meeting (which Dick Kerr attended).

TAB C Thoughts from [redacted] on how we should deal with Mexico (also produced for the 5 June SIG). 25X1

TAB D Memo from the Director to Bob Vickers and [redacted] last week on Mexico and [redacted] reply. 25X1 25X1

TAB E "Bootlegged" copy of INR talking points for Armacost for 5 June SIG.

[redacted] 25X1

Vickers is meeting Abrams this afternoon — he may have some insight for us tomorrow morning.

A

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SECRET [redacted] 25X1

17 June 1986

RECENT DEVELOPMENTS ON MEXICO

The last month has seen a flurry of USG activity related to Mexico:

-- Senator Helms held hearings on Mexico during 12-13 May which generated much negative Mexican reaction.

-- A SIG meeting on 23 May provided a forum for discussion of the current Mexican economic situation and the prospects for economic reform.

-- Under Secretary of State Elliot Abrams visited CIA for a roundtable on economic and political developments in Mexico on 4 June.

-- Senator Helms had called for another round of

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hearings on Mexico for 19 June involving CIA, State and Treasury. Those hearings have been postponed at least until the week of 23 June.

Negotiations between Mexico and its creditors, particularly the IMF, reached an impasse during the last month.

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-- Economic cabinet members appear confident that the debt ball is in our court and are merely waiting to see what the United States will come up with as a bailout package.

-- There is no evidence from the reporting that the Mexicans have eased their demands for an IMF agreement and new money with little or no conditionality attached.

-- Lack of progress toward an IMF agreement by the end of the month would weaken the hand of the moderates on de la Madrid's cabinet and generate intense pressure on the President for strong action.

B

3 June 1986

MEXICO: REACTION TO ALTERNATE POLICY PATHS

Neither the massive bail out in 1982, nor the more incremental approach employed since that time, have resulted in a solution to Mexico's financial and economic problems. What is generally agreed upon at this time is that the solution will not come about solely by the well-intentioned intervention of the United States or other outside actors. Mexico needs to undertake fundamental economic reforms, and its reluctance to do so has, and will continue, to thwart efforts to create an economically-viable Mexico. While de la Madrid is likely to muddle through to the end of his term without major political instability, the slow erosion of support for the ruling party now under way will accelerate, in our judgment, increasing prospects of a political breakdown over the longer term. What follows addresses Mexico City's present perspective on its financial options and provides our view of the likely Mexican reaction to a variety of US policy initiatives.

Mexican Perception of Options

The Mexicans have not devised any clear strategy for coping with their current financial problems.

--Mexican Government officials, instead, view their present economic troubles largely as the result of an abrupt fall in petroleum prices. As a result, they are counting on the United States, the IMF, and international creditors to fill the resulting financial gap.

--They know economic conditions are deteriorating but are unprepared to adopt politically unattractive and economically disruptive reform measures.

--In our judgment, de la Madrid believes political conditions at home severely constrain what reform measures he can adopt. He probably is concerned, for example, about imposing further hardships when the real purchasing power of most Mexicans already has fallen by over one-third since he assumed office in late 1982.

Moreover, we believe that President de la Madrid and his economic policy advisors are taking only a short-term view of the economic challenges facing the government.

--De la Madrid is moving closer to the end of his term in office, making it even more difficult to initiate far-reaching economic changes than in previous years of his administration.

--The President knows that the economic situation is costing the government and ruling Institutional Revolutionary Party (PRI) political support. In our view, he will not adopt economic reforms that hold a strong prospect of leading to social unrest.

--As a result, he is content to pursue a "muddle through" approach that will allow him to serve out his term without precipitating either a major economic or political crisis.

This perspective is partially the result of the Mexicans' view that the United States will bail them out if economic conditions become too severe.

--Mexican leaders are convinced that their country is too important to the United States for Washington to allow a prolonged economic crisis.

Exploring the Options

There are a number of possible scenarios given Mexico's current financial difficulties. They range from continuity in policy, on the one hand, to a fundamental financial jolt, on the other. They also include such options as benign neglect and a massive bail out. The advantages and disadvantages of these possible policy directions are explored below.

Pursuing An Incremental Approach

Because of domestic political constraints, de la Madrid probably would like to pursue an incremental approach to economic reform, making just enough changes in economic policy to assuage the concerns of the IMF and international creditors. In return for limited movement toward economic reform, the Mexicans expect US and international financial assistance to close the gap caused, in their view, by the fall in petroleum prices.

Reasonable positive movement could include:

--An expanded campaign for the promotion of nonoil exports. De la Madrid would have little trouble convincing Mexicans of the merit of diversifying the country's export base to protect it from shocks associated with a volatile oil market.

--Mexico also could be encouraged to be more open to foreign investment, expanding on recent examples such as the IBM decision and, more recently, offers to allow the Japanese majority ownership.

--The government also is likely to continue to move, although in a piecemeal fashion, to reduce government spending by selling or liquidating inefficient parastatals, raising prices on government-subsidized products and services, and holding the line on real wages.

By taking an incremental approach to policy change, Mexican officials would ensure that no one group was hurt too badly. A continuation of the policy of incremental reforms would be politically acceptable within Mexico, at least in the short-term.

--It would imply the perpetuation of statist economic policies and the dominance of domestic political considerations in economic deliberations.

Nonetheless, the incremental approach will neither solve Mexico's economic problems nor ease the negative impact of the continuing substantial net outflow of financial resources to service Mexico's $98 billion foreign debt.

--While Mexico may be able to boost nonoil exports by $1-2 billion over the short run, a continuation of present policies is unlikely to create the internationally competitive, diversified export base needed to take up the slack in Mexico's foundering petroleum export industry.

--Even though Mexico may be able to attract some new international investment by selectively allowing companies majority foreign ownership, poor domestic economic prospects, problems obtaining foreign exchange, import and price controls, and the fear that government officials will impose new restrictions once companies are established all will seriously limit new investment in Mexico.

--The limited inroads that Mexican officials are likely to make in shaving the burgeoning budget deficit probably will leave the Mexican economy in worse shape than when de la Madrid took over in 1982. Investment will continue to contract if the government continues to absorb almost all domestic credit. Prices also could soar if officials resort to an expansionary monetary policy to finance the revenue gap.

The principal stumbling block preventing major economic initiatives would be the President's reluctance to alienate key groups over the short run when, in many cases, the benefits of massive policy shifts would not be immediately felt. In fact, a large-scale campaign to make Mexico's nonoil exports more competitive--rather than just depending on export tax incentives, a competitive exchange rate, and a flagging domestic market to spur additional exports--would hurt key groups in Mexico.

--Import liberalization, which would have to be a central feature of any such move, would harm most Mexican businessmen whose industries are protected by high tariff walls and import quotas.

--Labor unions, likewise, would be adversely affected if increased foreign competition drove many employers out of business.

--If Mexico were to liberalize its foreign investment laws--instead of just agreeing to "interpret" them more liberally--we believe, as well as most Mexicans, that the resulting flood into the country of international businesses trying to gain a foothold in the Mexican market would force less efficient domestic producers out.

--Moves to reduce public-sector spending drastically would greatly affect labor union and other lower income wage earners who increasingly have come to depend on government job stability and subsidies on basic goods and services to soften the impact of sharp reductions in real wages.

Risking a Financial Shock

Alternatively, if Mexico's funding problems are not resolved, de la Madrid could face a major financial shock. This has inherent risks but presents some potential opportunities for the United States. If a major financial shock occurred, there would be substantial economic costs for Mexico as a result of a cutoff in trade credits and suspension of foreign debt payments.

--Mexican businessmen, particularly those engaged in trade or dependent on foreign materials as inputs, would be substantially hurt by the loss of credits, and many would be forced out of business. Moreover, businesses would suffer additional losses from decreased public-sector purchases.

--Mexicans would be hurt by the increase in unemployment due to the collapse of Mexican businesses and reluctance of foreign companies to invest in Mexico. Since Mexico usually imports between $1 and 3 billion in food each year, the loss of trade credits could decrease the availability and increase prices of food.

--In addition, the public industrial sector would be unable to purchase critical spare parts and capital equipment. For PEMEX, the state-run oil company, this would lead to a further erosion in maintenance, which could result in decreased production, or exploration for new reserves.

If Mexico City sustained a major financial shock and Washington was not immediately forthcoming with assistance, relations with Washington would deteriorate. As a result, depending in part on the length of the crisis, domestic leftists probably would gain somewhat greater political influence and the President, in our judgment, would be less inclined to select a moderate as his successor.

--The benefit of the "shock" approach would become apparent only if, and when, the Mexicans recognized the need to take stern measures to put their economic house in order and to do more to heed Washington's advice.

On the other hand, from a political perspective, if Mexico's financial crisis were allowed to deepen into a general economic breakdown, we do not believe that the government's hold on power would be jeopardized immediately.

--Nonetheless, it would hasten the slow erosion in the PRI's base of support that has been under way for some time. Middle class professionals, northerners, and members of the business community would become even more disaffected.

--Independent opposition parties on the left, such as the PSUM, and the right, such as the PAN, would step up their efforts to exploit the situation. In response, the government would tighten its control over their activities and resort to greater electoral manipulation.

--We believe the peasantry, which is poor, illiterate, and dispersed, would continue to prove pliant.

In the event of a major breakdown of the system, the government would have greater difficulty controlling organized labor. As conditions deteriorated, the government almost certainly would rely more heavily on the military to maintain itself in power.

--The armed forces probably would cooperate so long as their institutional interests were protected and it appeared most Mexicans still supported the system.

--Under extreme circumstances, the military might seize power in a situation of economic and political collapse.

At the same time, the current political balance of Mexico's leadership would shift and probably favor officials from the left or those who support more nationalistic policies.

--A major economic collapse would tend to hurt those within the government identified with Mexico's current economic policies. These officials have tended to be more moderate in their dealings with the United States and include Treasury Minister Silva Herzog, Commerce Minister Hernandez, and National Bank Director Mancera.

--Among the political winners would be the more vocally populist and nationalist officials in the government, such as Budget Minister Salinas. Leftists, including Foreign Minister Sepulveda, also would benefit.

Overall, the PRI would be faced with few opportunities as a result of an economic breakdown.

--Mexican officials probably would initially blame the United States for any financial crisis of this magnitude, regardless of the cause. This would provide their government with an opportunity to relieve mounting domestic pressures by using the event to focus responsibility on external forces rather than internal policies.

--After a display of nationalism, Mexican officials might use the crisis as an opening to approach the United States for assistance in exchange for reforms. If such an approach were made, the Mexicans probably would continue to insist on assistance before the reforms as a method of promoting their independence.

--In our judgment, there is only a slim chance the Mexicans would initiate reforms on their own in the face of an economic crisis.

Numerous problems would develop, however, which would test the PRI's ability to respond.

--Although discontent initially could be channeled into anti-US/pro-nationalist protests, the government and ruling PRI would eventually need to address the concerns of the people. With few resources at their disposal, this would be a difficult task resulting in increasing unrest and declining support for the PRI.

--Mexico City, in the interest of limiting public expenditures, would probably cut back on narcotics control efforts. This would allow traffickers almost free rein to cultivate and transport narcotics.

--Illegal immigration would also rise as Mexicans attempted to flee increasing unemployment and higher food prices.

--The loss of confidence in the Mexican political system that would result also would lead to increased capital flight, adding to the strains on the economy.

<u>Turning our back on Mexico</u>

Abandoning Mexico and allowing a financial crisis not only to occur, but also to deepen over time as a consequent cutoff in trade credits and other foreign financial inflows choked the Mexican economy, in our view, would have a negative impact on US-Mexico relations that would far outweigh any benefits that might accrue. The Mexicans would do all they could to avoid a cutoff of US support, placing the ball in Washington's court by telling us how willing they were to make changes if only we could back their attempts to obtain immediate financial relief.

--Continued US unwillingness to budge would make it easy for Mexico to portray Washington as the cause of Mexico's economic crisis.

--While continuing efforts to gain US assistance, Mexico most likely would up the ante, one step at a time, curbing efforts to control narcotics, missing debt payments, and colluding with other debtors to boost demands for debt relief, hoping that Washington would soften its position.

--As Mexico's situation became more precarious, world opinion could easily swing in Mexico's favor, particularly if it were perceived that US inactivity led to a collapse of the domestic economy. If taken to the extreme, the Soviet Union and other bloc countries could take advantage of the situation to make more political and economic inroads in Mexico.

--The resulting rift in US-Mexican relations probably could be healed only through extraordinary efforts on the part of Washington, and only after new administrations came to power in Mexico City and Washington.

The United States over the short term would be unlikely to obtain desirable results on the Mexican domestic front.

--Incremental economic reforms currently being pursued by the de la Madrid administration probably would be abandoned as the government increasingly became overwhelmed with the day-to-day task of coping with the resulting series of economic crises.

--The government would be likely to adopt even more populist policies such as nationalizing faltering industries to protect jobs, raising subsidies, and increasing price controls in an effort to soften the immediate economic and political blows to the Mexican system. Continued Mexican financial isolation also could lead to the election of a more populist government in 1988.

A refusal by the United States to budge could eventually result in a Mexican capitulation, even though we judge the chances for this as slim. What would be seen by Mexico as a hard and unyielding US position would militate against a positive outcome. If such an outcome resulted, however, it would only occur after new administrations entered office in both countries.

--A firm US policy stating our readiness to assist the Mexicans, but only if they first implemented fundamental economic policy changes, over time might show the Mexicans that we meant business.

--By holding back support and allowing the Mexican economy to hit bottom, we could possibly persuade de la Madrid's successor to see the benefits of drastically modifying Mexico's economic policy approach.

The "Big Carrot"

A major front-loaded bail out program might solve Mexico's immediate financial problems but, in our view, it is questionable whether it would produce any major gains on the economic-reform front.

--Mexican government officials probably would respond to large-scale financial inducements by promising a greater number of incremental reforms and even implementing a good many. Mexico probably would be inclined to move more rapidly toward increasing trade liberalization, easing foreign investment restrictions, and making public sector budget reductions. Movement in this direction probably could be hastened by forcing the government to follow through before all the funds were disbursed.

--Such a policy would promote good bilateral relations at least through the end of de la Madrid's term in 1988. At the same time, it would undercut the political strength of domestic leftists, enabling the President to select another moderate as his successor.

On a more negative note, there also would be the risk that a large financial aid package could cause the Mexicans to backslide on economic reforms.

--We believe that the breathing room provided by substantial financial inflows might convince Mexican policymakers that they could get by with only incremental changes since the US would always be there to bail them out.

--The domestic policy consensus within the de la Madrid administration against taking radical action and the President's fast approaching lame duck status, are likely to discourage the current government from taking politically risky steps, particularly if the economy is buoyed by outside financing.

--There is also a question as to the funding for this option. Bankers appeared to go along with the Baker Plan reluctantly. Drawing upon US funds for such a large program could spill over into the US domestic arena.

Seeking a Middle Road

Both the incremental and shock scenarios, while holding out some promise, also entail numerous risks. The incremental approach could fail to prod Mexico to make the reforms; the shock approach could quickly get out of control.

--Rewarding Mexico for what incremental reforms it does take would make it more difficult for the United States to be portrayed as harsh and unyielding.

--Even with these reforms and rewards, however, an impasse is coming when Mexico will not be able to make its debt payments.

--By not turning our back to Mexico, we might be able to orchestrate a financial crisis which is more manageable and less politically damaging as far as relations between the two countries is concerned.

Addendum

Q: What are the political/economic/social factors in the Mexican leadership structure which affect its ability to enact meaningful reform?

A: Numerous factors militate against meaningful reform at this time.

--There is no agreement within the government on an appropriate policy course. Cabinet ministers are divided, as is the leadership of the ruling party.

--Mexicans are highly nationalistic and do not want to appear to be caving in to pressure from Washington, especially in view of the recent US Senate hearings.

--Mexican leaders, particularly de la Madrid who is nearing the end of his term, are seeking immediate benefits with few costs. Most of the benefits of reform are in the long term, however, while the costs are more immediate.

--The Mexican political system is dominated by the presidency. De la Madrid has not been a strong leader, however, and has not provided firm direction for Mexican policy.

--Cabinet members and other Mexican leaders have already begun focusing attention on the succession process and away from substantive issues. Those who seek the presidency will eschew politically unpopular positions and will take care not to offend de la Madrid by promoting alternative policies. Infighting among Cabinet members, as each attempts to lessen the chances of other challengers, will also tend to paralyze new initiatives.

--Living standards have been declining since de la Madrid came to power. Mexico's leaders privately question whether they can exact greater sacrifices from the Mexican people while maintaining social peace.

--Powerful socio-economic impulses, including the potential gains Mexican officials can realize from corruption and bureaucratic red tape, also probably inhibit reform. For the most part, current Mexican political leaders have little personal incentive to promote reform of a system which got them where they are and will ensure they and their families are taken care of after they leave.

Q: What leverage can the United States bring to bear upon the Mexican leadership to bring about reform?

A: In our judgment, the Mexicans would be most supportive of reforms if, in return, they received a large front-loaded financial package, including new money or interest concessions.

--At the same time, the Mexicans are least likely to remain in compliance with any financial program that provides most of the benefits during its early stages.

Among the positive inducements the United States might use to promote reforms are these:

--A US presidential visit to underscore Washington's confidence.

--US assistance in putting together a new financial package or applying pressure on the IMF for a more acceptable agreement.

--New US commitments to purchase Mexican oil or to facilitate trade.

Alternatively, Washington could employ negative sanctions to influence Mexican policy.

--The United States could provide minimal financial assistance.

--The United States could threaten to tighten control over the border.

--Washington could decrease Mexico's share of US petroleum imports.

--Washington could be more ambiguous in its support for the de la Madrid administration and more critical of its policies.

C

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SECRET
[redacted] 25X1

27 May 1986

MEMORANDUM FOR: Deputy Director for Intelligence

FROM: [redacted] 25X1
Director of African and Latin American Analysis

SUBJECT: Dealing with Mexico

1. I suspect that we will be groping around on the issue of how to deal with Mexico for some time to come. Because of this, I wanted to pass along some personal thoughts.

2. In looking at the issue of Mexico and reform, I believe two political realities must be considered.

-- Mexico will see a new President enter the scene in December 1988. If history is a guide, mid to late 1987 and 1988 will be a time of political jockeying as the President is selected and he in turn choses a new cabinet.

-- The United States will be voting for a new President in November 1988. This means that the US election will begin to pick up speed at about the same time Mexican politics will begin to heat up.

2. Given these two facts, it is important that any Mexican initiative be well thought out. A policy misstep that bears fruit some time in mid to late 1987 could all too easily become embroiled in Presidential politics in either country. This, in turn, could sour relations for many years to come.

3. Considering the issue of timing, I would think that a mixture of an "incremental reform" package and "the big crisis" is the right way to go. Such a mixed strategy could be played out as follows:

-- Over the next 12 to 18 months the USG pushes hard, but quietly, for substantial but incremental reform in Mexico. Here the goals would be to both cultivate

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Mexican officials and show a US willingness to help. (If the USG was really willing to actively support bold action, it could hint that the more daring Mexico was willing to be--in the direction we wanted--the more creative we would be on the debt issue.) Given de la Madrid's difficulties in making decisions on bold moves, no major breakthroughs are likely absence severe economic problems. Even so, during this period we would have been putting down markers, and by not turning our backs made it possible for Mexican officials to approach the USG when bold action was needed.

-- During this period the USG should identify Mexican leaders who are responsive to US concerns. We should find ways to strengthen their political positions while weakening those opposed to reform. Here the goal would be not only to stregthen our position in the current government but also to ensure that our interests are served in the next administration.

-- During the next year or so, it is likely that Mexico will finally reach the funding impasse--foreign exchange will dry up, debt arrears will grow, and banks will prove unwilling to lend. As external sector problems are translated into the domestic economy, production will plummet while unemployment and inflation will rise. Politically, the Mexican government will debate what to do. If we have done our homework right, only two real options will come out of any internal discussions--(a) A Mexico that turns inward and is willing to live with economic hard times on a continuing basis or (b) A Mexico willing to turn to the United States as part of a "shrewd" Mexican move to restore the country's economic well being.

-- When the Mexicans turn to the USG they will have to come away with more than US words of support. We will need to be willing to match bold move for bold move. If Mexico comes up with a plan of action we really want to support, we may need to get the debt issue off their back. No matter what Mexico does, repaying a $100 billion dollars of principal is going to sap their system. Since 1982, out basic policy has been to sidestep the issue by encouraging the banks to refinance the debt (push the principal out into the future) and provide new funding (to pay the interest). In a Mexican financial crisis situation, we [redacted] 25X1

may want to consider new policy paths. Such options could include: Writing off official US debt; freezing all principal and interest payments in place for a fixed number of years; arranging a zero coupon bond for a commitment to provide a given stream of oil if a crisis situation developed in the future; or other such schemes. Regardless of the options selected, the point is that the USG could find itself in a setting conducive to reformulating its position on the debt issue.

4. The general scenario I have just laid out has a number of advantages over actively precipitating crisis during the next year or simply turning our backs and letting things happen. First, the USG would be seen as a positive actor, second we have the time to cultivate Mexican officials so that de la Madrid can act boldly in the closing days of his Presidency, and the new government can buy into the program. Third, such an approach helps reduce the chance that a Mexican crisis will become a political issue during the US election, a time when US policy moves will be slow at best. Even if such an approach were not workable, approved, and appropriate we should still be sensitive to the issue of timing given the convergency of elections in the United States and Mexico just over the horizon.

[redacted] 25X1

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D

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SECRET

Executive Registry
86- 2681

12 June 1986

MEMORANDUM FOR: National Intelligence Officer for Latin America
National Intelligence Officer for Econonics

FROM: Director of Central Intelligence

SUBJECT: Mexico

1. I'd like to get a message to Treasury, State and the White House on the Mexican situation along these lines:

- Merely putting up dollars to bail Mexico out financially is like throwing them away. Every dollar we put down there has a rubber band on it which snaps back to New York.

- Therefore, we need to get in return for the dollars we provide definite commitments for the Mexicans to do things which will move their economic and fiscal situation. A list of specific commitments which could be asked for include the following:

  -- Institute production sharing for PEMEX.

  -- Suspend foreign investment law.

  -- Let the peso go free.

  -- Promise to stop intervening in foreign exchange markets.

  -- Offer private capital, foreign or domestic, participation in state-owned industries.

  -- Stop protecting Mexican airlines--let charters come in--US, Canadian, European.

  -- Talk about a set-aside plan for debt obligation, maybe using equity in state-owned companies, possibly cooperation with Japan, public and private investments.

  -- Other steps to encourage tourism and foreign investment.

  -- Agree to quiet US/Mexican joint surveillance of drug activities on both sides of the border.

2. I would like your reaction to this and any ideas on how something like this might be formulated and put into the context of the discussions which are going on or anticipated.

William J. Casey

25X1

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DCI signed this
and asked that it
be sent to Shultz,
Baker, and Volcker.

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SECRET
The Director of Central Intelligence

Washington, D.C. 20505

National Intelligence Council

NIC 02857-86
13 June 1986

MEMORANDUM FOR: Director of Central Intelligence
Deputy Director of Central Intelligence

THROUGH: Acting Chairman, National Intelligence Council

FROM: [redacted] 25X1
Acting National Intelligence Officer for Economics

SUBJECT: The Mexican Financial Crisis

1. The enclosed draft is for your approval. In addition to your suggestions for changes, I will need a list of recipients.

2. For your information, it appears that Treasury is still sitting back and is not yet preparing a package. The press overplayed Mulford's remarks on Tuesday to imply that a package was in the works. Mulford was just trying to bring the Mexicans back to the table with the IMF and World Bank. Jim Conrow tells me it looks like Mexico will sign an agreement with the IMF by the end of June.

3. You may want to include the Chairman of the Federal Reserve on the distribution. Volker was in Mexico City on Monday.

[redacted] 25X1

Attachment:
Draft Memo as stated

APPROVED:

Director of Central Intelligence

Date

CL BY SIGNER
DECL: OADR

SECRET

NIC #02857
13 June 1986

SUBJECT: The Mexican Financial Crisis

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A/NIO/ECON [redacted] 25X1

DRAFT

MEMORANDUM FOR:

SUBJECT: The Mexican Financial Crisis

I understand that the IMF and World Bank expect to reach agreement with Mexico by the end of June on terms for another financial bailout. I am concerned that given Mexico's track record, the weakness of the present government, and the constraints posed by deteriorating economic conditions, the terms of any bailout will fall far short of what is needed to produce any real changes. A bailout with new money alone will be just throwing dollars away--every dollar we put down there has a rubber band on it which snaps back to US banks.

We need to agree on a firm set of commitments beyond the obvious elements of a stock IMF program that targets only public sector deficits, inflation, and future trade liberalization. I think we should press forward on two fronts. First we should push hard now for conditions that, although politically difficult, are absolutely necessary to prevent a recurrence of another financial crisis within the next year or two. Secondly, we need to come up with a set of longer term goals which, while more politically onerous for Mexico, are necessary for long-term improvement. The overall objective is to allow Mexico to improve domestic conditions and make better use of the trade and financial benefits which will inevitably flow from a closer relationship with the private sector in the US and abroad.

The near-term actions should include:

-- Allowing the peso to float freely.

-- Suspending foreign investment laws requiring majority Mexican ownership.

-- Facilitating debt equity swaps both for state-owned corporations and private sector investment.

On this last point, one banker told us that Mexico is not giving full peso value on debt equity swaps. Hence the debt was being discounted both when purchased from the banks and later when turned in to the government for pesos. On the political front, I think we should also push for an agreement for better cooperation on joint monitoring of drug-related activities along the border.

As to the longer-term reforms, which necessarily carry a high political cost for the PRI, we should press for:

-- Production sharing agreements with PEMEX to allow foreign firms to participate and share the cost of oil exploration and development.

-- Return of nationalized banks to the private sector.

-- A realistic program to speed up liquidation of inefficient public sector firms.

Overall, we should emphasize to Mexico that its biggest asset is not oil but the presence of a strong US economy north of the border. We should make clear that we stand ready to work with them to help Mexico grow without impinging on its political sovereignty. Our relations with Canada, although troublesome at times, show clearly that tremendous mutual economic benefits can be realized without a loss of sovereignty.

Lastly, I am a bit disturbed by the Mexican reaction to the conciliatory statements made by US officials over the past week. I realize that the statements were aimed at cooling off the Mexican rhetoric and getting the IMF negotiations back on track--goals that were obviously realized. Intelligence shows, however, that the Mexicans interpreted the remarks as a sign that the US was concerned by the threats they made last week and had decided to become more conciliatory--an impression that, unless corrected, could forestall any real moves toward reform.

William J. Casey

E

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United States Department of State

Washington, D. C. 20520

MAY 29 1986

SECRET

INFORMATION MEMORANDUM
S/S

TO: P - Mr. Armacost

FROM: INR - Morton I. Abramowitz

SUBJECT: Responses to Questions for Mexico Inter-Agency Working Group

Attached are responses to the first four questions which will be analyzed at the next Mexico Inter-Agency Working Group meeting.

Attachment
As stated

SECRET
DECL: OADR

Question 1: What are the political consequences for Mexico of a major financial and economic breakdown?

A major financial breakdown would occur if Mexico were to decide to default on its foreign debt, a decision most likely to be brought on by a failure to secure foreign financing sufficient to prevent a precipitous decline in GDP. Faced with this prospect, the government could choose to default on its debt in order to conserve foreign exchange to pay for essential imports. But the chances are remote that such a breakdown will occur. A growing shortage of foreign exchange, coupled with Mexico falling into arrears on some foreign payments, would not constitute a major economic and financial breakdown.

A declaration of default likely would induce most of Mexico's bank creditors to cut off trade credits, and they could move to attach Mexican assets overseas. Because the subsequent reactions on the part of creditors are uncertain, it is difficult to predict the consequences of declaring default, although capital flight no doubt would accelerate. But events in Peru over the past year suggest that, on a much smaller and less dramatic scale, a country can survive a cut-off of most trade credits in the short term and have positive economic growth. The short-term economic amd political effects of a default declaration might not be cataclysmic, but the medium and long-term repercussions could be far-reaching.

The most likely immediate political consequence of an economic crunch--in addition to the inevitable significant increase in northward-bound emigration--would be the impact on the presidential succession. The jockeying among presidential hopefuls for the 1988 election is already underway. A major failure of De la Madrid's economic policy of austerity and incremental reforms would favor the left wing of the ruling Institutional Revolutionary Party (PRI). A president from this faction would resist structural economic reform and favor more statist policies. Politically, he would support nationalist and anti-American positions.

Although an economic crisis would not lead immediately to major destabilization of the Mexican political system, strains already present would increase. With growing inflation and unemployment, and a decreased economic pie available for distribution by the system, the current relatively peaceful social-political climate could change. Labor and peasant unrest and demonstrations by radical students would increase and would probably lead to greater use of repression by security forces. In time, growing dissatisfaction could give rise to new extreme leftwing organizations or greater support for existing peripheral groups.

Meanwhile, the private business sector--particularly in the northern border states--would react to the stifling statist economic climate by more actively supporting the opposition National Action party (PAN). The PRI would be increasingly unwilling to concede any significant elected posts to the PAN, but would have to resort to ever more blatant fraud to assure its dominance in the north. Unlike in 1985, PAN supporters would be less likely to accept the fraud-induced defeat peacefully.

In time, therefore, the ruling PRI would find itself challenged on the left and on the right. These strains would be reinforced by the regional tension between the impoverished, more populous south and the conservative, US-oriented and relatively prosperous north.

Mexico's efforts to fight narcotics trafficking would likely be significantly reduced if not abandoned in the event of an economic crisis. In the anti-American climate which would likely prevail, the termination of an effort which was viewed as responding in large part to an American problem would be popular. The move would free valuable government resources, and the increased narcotics production and trafficking would provide a badly needed source of jobs and capital. Over the longer term, obviously, the growing influence of the narcotics traffic would be destabilizing.

Question 2: What are the economic consequences for Mexico of a continuation of the policy of incremental reforms?

Economic policy under de la Madrid blends incremental reform with sporadic retreat from reforms. This policy mix is unlikely to make more than a marginal improvement in the now four-year-old trend of stagnant GDP growth. Stagnant growth in the coming years will come on top of this year's expected 3 to 5 percent decline in GDP.

Mexico's economic performance depends on exogenous factors such as availability of external financing and the terms of trade. The most likely economic scenario, one of little or no real growth, assumes minimal levels of external financing ($2-3 billion yearly) would be available as in the past, and that there is no large deterioration in the terms of trade. Per capita GDP, which has fallen nine percent since 1981, would continue to decline.

The most important consequence of continuing current policies is that foreign exchange crises are likely to recur. There likely would be slow or no progress on reducing the fiscal deficit. Reductions in the deficit would come mainly from higher revenues as oil exports recover, and there would be little progress on privatizing government enterprises. Inflows of foreign investment--now running at one-third of the 1980 level--would not likely bounce back, especially as de la Madrid has backtracked on liberalizing foreign investment laws. Progress on trade liberalization would be slow, constrained by the need to conserve foreign exchange and by a desire to protect politically well-connected industries and parastatal companies.

The present policies depress the potential of the more dynamic sectors of the Mexican economy. Foreign investment could play a much more significant role than it does now in developing non-oil products, which account for one-third of exports. The in-bond industries ("maquiladoras") would particularly benefit from a more open economy. Although they may expand annually by ten percent or so even if present policies continue, they begin from a small base and will have only a small impact unless their growth is accelerated. These companies employed 220,000 persons out of the total workforce of 26 to 27 million in 1985, generating $1.3 billion in value-added in an economy of $180 billion. Much of Mexico's industrial base still consists of parastatal corporations (15 to 20 percent) and protected, import-substitution industries.

We would continue to see periodic retreats from pursuing economic reforms. These retreats have taken place when the financial need to please creditors by pursuing reforms has lessened, or when political considerations have made retreat desirable. De la Madrid already has shown that he will abandon long-term policies for short-term political gains. The slow progress of incremental reforms would be further diluted by these periodic digressions.

Question 3: What are the political/economic/social factors in the Mexican leadership structure which affect its ability to enact meaningful reforms? What arguments does a Mexican reformist use with his own political colleagues to argue his case?

The Mexican government/party system is based on consensus and cooptation. Over the years, the PRI has absorbed all significant sectors of the society, including labor and business, peasants and intellectuals. While this consensus has been the basis of the PRI's strength and durability, it also greatly inhibits the system's ability to change. Since the agreement of all factions of the PRI must be obtained before a president can institute any policy, and since reforms would have negative consequences for at least some elements within the ruling structure, any major departures from the status quo require consummate political and leadership skills.

President De la Madrid, despite his good intentions and technical economic expertise, has shown himself not a skillful master of his own party. As a result of his perceived weakness as a leader, the jockeying among potential contenders as his successor has begun even earlier than usual. Many of the party's leaders--including Finance Secretary Silva Herzog, who otherwise would be a leading proponent of reform--are now concentrating on their own political futures.

A Mexican reformist would argue that economic development led by the oil boom and by import substitution has run its course, and that Mexico must generate increased non-oil exports to promote economic growth. Export industries are needed to generate jobs that import substitution industry and agriculture have been unable to create. He would say that resuming rapid economic growth is vital to the long-term interests of the PRI, and would stress that new strategies must be pursued to get this growth re-started.

Question 4: What leverage can we bring to bear upon the Mexican leaderhsip to bring about reforms?

We have an extremely limited ability to bring leverage to bear upon the Mexican leadership to implement reforms. Because of the nature of the relationship between our two countries, almost any negative incentive applied to Mexico would cause as much--or more--damage to US interests as to Mexico. For example, any attempt limit free movement across the border would catch the attention of the Mexican leadership but would also have significant economic and domestic political repercussions in the US.

Although the Mexicans are sensitive to criticism, efforts to influence their behavior by publicly embarrassing the government do serious damage to the overall bilateral relationship and reinforce traditional anti-Yankee nationalism among all sectors in Mexico. The recent fall-out from the Senate subcommittee hearings demonstrates the depth of resentment among both government officials and the general public to perceived US "meddling" in Mexican affairs.

In assisting Mexico to secure external financing, we indirectly have been able to secure its commitment to implement economic reforms and/or austerity. The point of greatest leverage comes as the financing is arranged. The problems occur in implementing reforms, as securing the financing lessens the immediate need for reform. The reduced sense of urgency, coupled with domestic political pressures against reform, have scuttled many of de la Madrid's initiatives.

Providing enhanced bilateral trade benefits to Mexico could enhance the prospects for reform. Increased access to US markets could induce Mexican and foreign investment, and de la Madrid likely would try to help the private sector take advantage. But the private sector response will be much less if market access is tied directly to economic reforms, as private investors would hesitate to risk capital if their market depends upon the government carrying out reforms.

Mexico's external financing needs this year most likely will be in the range of $4.5-6.5 billion. The financing needed depends on variables such as oil revenues, the size of import cutbacks, and capital flight. The resources for this magnitude of external financing could be put together, drawing upon a variety of sources:

--IMF stand-by and/or EFF programs.
--World Bank sectoral loans
--IDB loans
--CCC credits
--Paris Club rescheduling
--Commercial banks

Mexico has expressed reluctance to increase its debt stock substantially. It instead is pushing for measures such as interest rate caps on its commercial bank debt and lower loan spreads, which would directly reduce present and future debt service. Some European banks reportedly are willing to consider such proposals, provided an IMF program is in place. Also, debt for equity swaps could be of marginal benefit in reducing the stock of Mexican debt.

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